

Tax Regulation of Transfer Pricing: National And International Specifics

Dmitriy I. Ryakhovsky¹; Irina Albertovna Duborkina²; Nadezhda Nikolaevna Kozhukhova³; Andrey Nikolaevich Zharov⁴

¹Financial University under the Government of the Russian Federation, Moscow, Russia.

²Russian State University of Tourism and Service, Moscow, Russia.

³Sevastopol Branch of Lomonosov Moscow State University, Sevastopol, Russia.

⁴Peoples' Friendship University of Russia (RUDN University), Moscow, Russia.

Abstract

This article studies the main provisions and features of transfer pricing regulation in the Russian and international tax practice. In the context of the transition to the digital economy, the current transfer pricing methods fail to match modern business models in terms of approaches to value creation. Thus, it is necessary to examine the main aspects of developing the state regulation of transfer pricing in the Russian Federation to determine the main shortcomings of the Russian price control in controlled transactions. The article presents the typical features of controlled transactions and the prospective use of blockchain technology in the management of transfer pricing.

Key-words: Legal Regulation, Controlled Transactions, Business Models, Blockchain Technology.

1. Introduction

The effective implementation of economic policies by the Russian Federation and ensuring the fiscal interests of the state and municipalities are conditioned by the use of tax control measures as a special form of state regulation (Saydulaev et al.: 2020; Krasnov et al.: 2020). Tax control is a set of measures used by the Russian state regulation to implement effective economic policies and protect the fiscal interests of the state and municipalities. The legal regulation of tax control should also harmonize legal relations between groups of companies and the state represented by its tax authorities. Businesses should be able to develop, increase their profits and pay a fair amount of taxes to the state (Fedyunin: 2019).

The development of market relations encourages business entities to look for methods to ensure their stability and increase competitiveness. One of such methods is transfer pricing. A transfer price is an intercompany price that is used in the interchange of goods or services and transactions and accountings between corporate divisions and branches. It is always set confidentially and constitutes a commercial secret. Optimal transfer prices provide business entities with a maximum marginal income (Grundel et al.: 2020; Mazurina et al.: 2020; Abdulkadirov et al.: 2020).

Due to the growing transnationalization of the global economy, the fiscal authorities of many countries impose taxes and customs duties on participants in foreign economic activity that implement cross-border transactions between interrelated (interdependent) entities. The use of transfer pricing by foreign trade participants (the possibility of using deliberately low prices between interconnected (interdependent) entities when concluding a foreign trade contract) causes a shortfall in income to national budgets from an income tax, personal income tax, mineral extraction tax, value added tax and customs duties. According to expert estimates, the share of transfer transactions is about 50% of the world economic turnover and this figure continues to grow rapidly. Using the mechanism of transfer prices, transnational corporations try to reduce the tax burden by an average of 10-15%, which is considered a good result for developed economies (Boldyreva: 2019). From the standpoint of international business, transfer pricing is an effective economic tool. From the viewpoint of state interests, transfer pricing is a mechanism for minimizing tax payments and customs duties.

At present, there is a certain contradiction. On the one hand, tax legal relations between market participants and government agencies actively transform. On the other hand, the number of tax disputes over transfer pricing increases from year to year. Currently, many scholars question the possibility of ensuring a balance of interests between taxpayers and state in the tax control of transfer pricing. For example, A.N. Fedyunin (2019), I.A. Boldyreva (2019), M.O. Kakaulina (2019), etc. studied the tax control of transfer pricing in transactions. However, modern surveys on transfer pricing become even more relevant in the context of the impact of the global digital environment on the effectiveness of tax control in this area. There are still not enough studies on this matter. The research hypothesis is that many tools of the current transfer pricing mechanism in the Russian Federation are outdated but it is possible to improve the existing tax control by creating a unified system of tax regulation based on blockchain technologies.

2. Methods

We selected the dialectical method of cognition as the main research method. The method of systemic analysis was used to study Russian tax control over transactions and systems based on international standards. The statistical method showed the reduced tax burden of companies utilizing transactions with transfer pricing. The historical method enabled us to determine the developmental stages of the regulation of these transactions. The comparative-legal method revealed the possibility of applying international experience in the regulation of transfer pricing by Russian legislation. To prove the above-mentioned hypothesis, we used information from trusted Internet sites, legal acts and scientific views set out in articles.

3. Results

The concept of "transfer pricing" was introduced by the United States in the 1960s, when the US economy started to leave the geographical boundaries of one state and its large corporations began to establish their divisions in other countries, including to reduce the tax burden and other production costs (Baranova: 2015).

In Russia, the Tax Code of the Russian Federation (Nalogovyi kodeks Rossiiskoi Federatsii: 1998, 2000) regulates transfer pricing (Article 40 of the Tax Code of the Russian Federation). The article offers a certain compromise between the state and business. Without directly prohibiting transfer pricing transactions and providing holding companies with a certain freedom in the formation of internal prices, this rule limits the tax efficiency of transfer pricing and sets the permitted deviation of prices from market prices by no more than 20% (otherwise, taxes are calculated based on market prices). Russian legislation in the tax administration of transfer prices is being improved to bring it in line with international standards. In the process, a new concept was introduced into the Tax Code of the Russian Federation – "commercial or financial conditions different from those that would take place in similar transactions between persons that are not interdependent (market prices)". The list of controlled transactions comprises foreign trade transactions with natural resources (oil, metals and mineral fertilizers) and transactions with persons registered in states included into the so-called "black list" by the Ministry of Finance of the Russian Federation if the total income from such transactions exceeds 60 million rubles per year (Boldyreva: 2019). The crucial points in the regulation of transfer pricing that require legislative elaboration are as follows: features of

interdependence (interconnectedness) of persons carrying out transactions; the list of controlled transactions, including intellectual property items; the list of methods for determining market prices and conditions for their use; the introduction of preliminary agreements on pricing (Boldyreva, Klyukovich: 2015).

The interdependence of persons making foreign trade transactions is the basis for checking the correctness of prices by tax authorities since this factor determines the controllability of transactions. Under Russian legislation, there are 11 categories of interdependent persons, while the previous edition of the Tax Code of the Russian Federation included only three categories. The interdependence of such persons is determined by the following conditions: one organization possesses a direct and (or) indirect share interest in another organization, and the aggregate proportion of such interest exceeds 25%; a third party possesses a direct and (or) indirect share of both parties to some transaction, and the aggregate proportion of such interest exceeds 25%; one party to a transaction has the right to appoint at least 50% of the management of the other party; a third party appoints the heads of both parties to some transaction; more than 50% of the management of both parties to a transaction coincide; one party to a transaction is the manager of the other party; when both parties to a transaction belong to a group of several organizations, whose participants directly own more than 50% of each other's capital; there are family relations between the parties to a transaction (Baranova: 2015). When determining market prices and customs values, tax and customs authorities should take into account that the interdependence of parties can be not obvious but rather hidden, i.e. it does not fall under common standards. Such transactions include, in particular: transactions on unusual terms in relation to the price level, interest rate, guarantees or payment conditions; transactions in which there is no economic logic or the reasons for its implementation are unclear; transactions whose content differs from their form; transactions that are carried out in an atypical or unusual way or by persons who usually do not participate in such transactions; transactions with buyers or sellers that are especially large and important in comparison with other transactions; non-fixed transactions, for example, the provision or receipt of free information or consulting services (Zubenko et al.: 2020; Nikitina et al.: 2020; Bondarenko: 2020). From the viewpoint of taxation and determining customs values, transfer pricing regulation aims at providing a market price for calculating taxes and duties. When working with interdependent parties, fiscal authorities (including tax and customs authorities) strive to solve their specific tasks: for tax purposes, the use of market prices ensures the market distribution of profits between different jurisdictions (countries) where the companies involved in the transactions under consideration pay taxes. For

customs purposes, the determination of market prices is important to ensure the "market" prices for imported goods and the calculation of customs duties and taxes (Zaikina, Rubchenko: 2008). In relation to tools used to achieve the goal set, tax authorities adjust the costs of purchasing goods by participants in foreign economic activity, and customs authorities regulate the customs value of imported goods. To determine customs values, customs authorities need to ensure that the transaction price actually paid or payable by interdependent parties (transfer price) is acceptable for customs purposes. The solution is to study the circumstances of a certain transaction and apply test values.

According to G.A. Makhovikova (2014), the field of transfer pricing experiences the following problems: information awareness as the key factor in choosing a method for determining prices; major labor and financial costs; no clear methods for confirming market prices in transactions. In particular, the methods for determining the conformity of the applied prices are imperfect. Their use is hindered by the following factors: 1) the complex search for a similar transaction between non-interdependent counterparties; 2) the need to seriously adjust accounting, transaction indicators and price indicators for their comparison; 3) difficulties in collecting information about foreign affiliates involved in a controlled transaction (Kakaulina, Khmura: 2019).

The above-mentioned problems are confirmed by the fact that the number of tax disputes on transfer pricing does not decrease, which proves the lack of sufficient legal support for tax authorities conducting tax control. In many cases, tax control implemented by tax authorities contradicts the existing tax legislation. The relevant law establishes certain cases in which tax authorities have the right to check the correctness of the prices applied, but these criteria are not taken into account in 18% of cases considered by them (Artyukh: 2018). This also testifies to the inconsistency of tax legislation in the area of tax control over transfer pricing and the incorrect application of these norms by tax authorities.

4. Discussion

Tax aspects of transfer pricing have been subject to international state regulation since the 1970s. The main idea of transfer pricing outlined by the Organization for Economic Co-operation and Development (OECD) is the "arm's length" principle, i.e. the fair distribution of taxes among countries and avoidance of double taxation (Neighbour: 2002). In the framework of this principle, it is necessary to check the parameters of transactions between interdependent entities in the context of transactions with independent counterparties. If there are discrepancies in transactions with

independent counterparties, one should estimate the profit that could arise in the relevant market conditions. The OECD first issued transfer pricing guidelines in 1979, updated them in 1984 and 1995 and still regularly renews them. Article 9 of the OECD Model Tax Convention allows charging additional taxes if goods, works or services are sold below the price established between independent counterparties. These provisions are often included in treaties for the avoidance of double taxation (OECD: 2017a). According to this article, if one state notices the fact of price manipulation, additional taxes are charged in transactions with due regard to market prices, while the other state, in whose territory the other party to the transaction is located, recognizes these alterations. This mechanism is called symmetric adjustments to the tax base. Article 9 of the OECD Model Tax Convention also provides the basic principles for regulating transfer prices. However, the main criteria and parameters for recognizing the interdependence of persons and the total value of controlled transactions and methods for determining market prices are established by each state independently.

Currently, the main document in the international tax regulation of transfer pricing is the OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" published in 1995 (OECD: 2017b). These guidelines were adopted due to the relative and absolute growth of intra-company trade. In the 1990s, the share of import and export in intra-company trade was 36% and 43%, respectively, in the US; 34% and 18% in France; 25% and 14% in Japan; 38% and 9% in Sweden (Gordeeva: 2012). The effective application of the OECD guidelines is associated with certain conditions: 1. Transfer pricing is built over a solid technological base, which forms quality information and ensures its quick exchange; 2. Western enterprises have a well-developed management accounting system considering the overall strategy of such an enterprise; 3. Western enterprises have well-trained middle-level managers experienced in the field of economy and management; 4. A method of transfer pricing is selected by enterprises independently and is conditioned by the specifics of their activities (Lazareva: 2016). Management accounting is the basis for forming transfer prices in the West. A management accounting system accurately calculates the cost of products and services, as well as allocates centers for financial responsibility. Management accounting includes three aspects: accounting at full cost, by centers for responsibility and production cost based on variable production costs ("direct costs"). The long-term threshold of transfer prices is determined by the total cost of goods, while the short-term one is based on variable costs.

The OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" comprise two groups of methods: methods based on transaction analysis and

methods based on profit analysis. Their methodic recommendations provide three main methods based on transaction analysis, including the comparable uncontrolled price method, the resale price method and the cost-plus method. Taxpayers living in the OECD countries legally calculate special prices for transactions that might be subject to tax control. The method of transfer pricing is selected after analyzing a specific situation and transaction since most OECD countries neglect the strict hierarchy of priority using different methods. Under the comparable uncontrolled price method, the price of goods under a controlled transaction is compared with the price of similar goods for comparable transactions (both internal and external). This method cannot be used automatically since it is necessary to consider the similarity of economic conditions and circumstances. The methodic recommendations on transfer pricing define comparability factors, including characteristics of goods or services; contractual terms established between the parties; economic circumstances determining a transaction; the strategy of economic development. Taking into account these differences between controlled and potentially comparable transactions, the adjusted price of the latter is the target price for a controlled transaction.

The advantage of the comparable uncontrolled price method lies in its objective nature. Its disadvantages are the lack of clear definitions of sufficient criteria to confirm the identity or homogeneity of some goods. The resale price method is preferred when purchasing a product from an interdependent supplier and then reselling it to a non-dependent buyer without recycling. The resale price of an item is reduced by the amount of gross margin. To determine the margin value, it is necessary to obtain data on comparable transactions. The market price of such an item will be calculated from the margin after adjusting it for other costs associated with the acquisition of this item. This method is used in cases where an enterprise does not have the necessary data on comparable transactions and the differences between controlled and comparable transactions are difficult to measure. The method is easy to use in calculating transfer prices. However, it does not provide accurate calculations and they can be consequently challenged in courts (Kholopov et al: 2019). The cost-plus method determines the supplier's expenses in a controlled transaction regarding both direct and indirect costs of production and sale of goods. The selling price is the sum of costs and profits. The profit per unit is determined through the standard of profitability typical of a given activity. According to the cost-plus method, the profit is a certain value before the deduction of fixed costs. This method is efficient in relation to the provision of services. The advantage of this method is the objectivity and clarity of calculations. However, it has certain drawbacks: the responsibility center is not interested in reducing its actual expenses and the transfer price based on the full cost price does

not allow to control the efficiency of the responsibility center. If the above-mentioned methods of transfer pricing do not bring positive results, the legislation of the OECD member states utilizes methods based on profit analysis, in particular, the profit split method and the transactional net margin method. The profit split method aims at determining the profit that interdependent entities receive from joint transactions and distribute among themselves depending on the degree of their participation in generating this profit (Khmura: 2019). The party's contribution is determined through a functional analysis with due regard to the assets used, the risks assumed and external market factors. The transactional net margin method is used to calculate the net margin in relation to some base (for example, regarding costs and assets) that taxpayers receive from a controlled transaction. The net income is considered after deducting all the costs, both variable and fixed.

At present, Russian tax legislation has come closer to international standards for imposing control over transfer pricing in such aspects as:

The number of criteria for recognizing persons as interdependent;

Conditions for determining controlled transactions;

The number of methods for identifying market prices in transactions;

The obligation to notify tax authorities about the implementation of controlled transactions;

The interval of market prices (profitability);

The right to symmetric adjustments for parties in controlled transactions;

Providing the opportunity to conclude an agreement on pricing for tax purposes.

Although the Russian Federation is not an OECD member country, it takes an active part in the implementation of new mechanisms to control transfer pricing and improve the interaction between member countries and OECD observers to determine cross-border transactions in conditions that differ from market.

To solve the above-mentioned issues and identify and manage transactions between interdependent entities, it is necessary to use a blockchain technology. The introduction of a blockchain-based platform for implementing inter-company transactions into the activities of transnational corporations will allow keeping records of the entire chain of controlled transactions.

A group of scholars from different countries has developed a technique of organizing inter-company business in a blockchain environment (Zhang et al.: 2019; Iudina et al.: 2020). Transnational corporations can create a distributed ledger to complement the existing systems for processing transactions, recording supporting documents and incorporating automatic compliance throughout their business network. Their subsidiaries, accounting, finance and inter-company

departments, internal and external auditors and regulatory bodies in each jurisdiction can have authorized access to the distributed ledger through a local subsidiary, which is safe and secure. Such a blockchain-based distributed ledger can ensure that transactions comply with the rules of each jurisdiction.

Thus, a blockchain technology strengthens internal and external financial control over the implementation of transactions among interdependent companies and helps them quickly and in time apply the existing methods of adjusting transfer prices (Khmura: 2019). The introduction of a blockchain technology reduces the risk of falsification of documents and eliminates the possibility of interference and manipulation with shipping documents.

5. Conclusion

The study has demonstrated that transfer pricing is not a tax violation but is a part of the tax policy of companies seeking to minimize their tax burden. Tax authorities are to eliminate the influence of interdependence on the terms of transactions, without forgetting that there is interference in legitimate business activities that is not prohibited by law. The extent of such interference should have clear legal boundaries. Therefore, it is necessary to form clearer conceptual and methodological foundations of transfer pricing which are not yet available in Russia. If moving to the digital economy, it is advisable to introduce methods based on a blockchain technology into the tax control over transactions of interdependent companies. This approach will allow keeping records of the entire chain of controlled transactions. Thus, the research hypothesis seems to be proven. Many interesting issues of transfer pricing remain outside the scope of this article, including ways to achieve a balance of interests between state and taxpayers that use transactions between interdependent companies to minimize tax payments.

References

- ABDULKADIROV, U.U., ZASCO, V.N., STEPANOV, D.A. (2020). *Regulation of securities market derivatives: experience and prospects*. Revista Inclusiones, 7(Especial), 108-118.
- ARTYUKH, A. (2018). Tax results of 2018: *dreams of predictability are still dreams*. December 28, 2018.
https://zakon.ru/blog/2018/12/28/nalogovye_itogi_2018_goda_mechty_o_predskazuemosti_ostayutsya_mechtami

BARANOVA, A.B. (2015). *The origin of transfer pricing. Problems. Risks. Possible solutions.* Molodoi uchenyi, 19, 356-359.

BOLDYREVA, I.A. (2019). The specifics of taxation and customs duties in foreign economic activities in the conditions of transfer pricing. State and business. Ecosystem of digital economy: *The proceedings of the 11th International scientific conference*, April 24-26, 2019, St. Petersburg, Russia. Severo-Zapadnyi institut upravleniya RANKhiGS pri Prezidente RF, pp. 32-37.

BOLDYREVA, I.A., KLYUKOVICH, Z.A. (2015). *Taxes and customs duties of foreign business activities upon transfer pricing.* Audit i finansovyi analiz, 4, 25-30.

BONDARENKO, T.G. (2020). *Comparative Analysis of Implementation Targets of National Projects in Developed Countries Managing Socio-Economic Indicators in Russia.* Utopía y Praxis Latinoamericana, 25(5), 370-378.

FEDYUNIN, A.N. (2019). *The legal regulation of tax control in the sphere of transfer pricing: ensuring a balance of interests between taxpayers and state*, in: N.V. Valuyskov, O.Yu. Grechenkova, L.R. Barashyan (eds.), *Development of legal science and the problem of overcoming gaps in law: The collection of scientific articles on the basis of the 3rd International round-table discussion*, April 30, 2019, Shakhty, Rostov-on-Don, Russia. Shakhty: OOO "Konvert", pp. 155-162.

GORDEEVA, O.V. (2012). *The price factor of tax risks: transfer pricing.* Finansy i kredit, 3, 33-37.

GRUNDEL, L.P., NAZAROVA, N.A., KOSTIN, A.A., KNIAZEVA, A.V., GORBATKO, E.S. (2020). State Regulation of Environmental Taxes and Fees: National and International Experience. *Journal of Environmental Management and Tourism*, 11(1), 159-166.

IUDINA, S.V., TSOVMA, D.V. (2020). *Strategic Decisions Concerning Subsidiaries and Affiliates in a Group of Companies: Computational Analytical Tools.* Utopía y Praxis Latinoamericana, 25(5), 63-76.

KAKAULINA, M.O., KHMURA, S.V. (2019). *The stages of state regulation in the sphere of transfer pricing and prospects of its development within the framework of digital economy.* Vestnik UrFU. Seriya: Ekonomika i upravlenie, 18(5), 681-708.

KHMURA, S.V. (2019). Methods for the tax control of transfer pricing and prospects for their implementation in the conditions of digital economy, in: O.A. Tsepelev (ed.), *Rossiya i Kitai: vektor razvitiya [Russia and China: vector of development]. The proceedings of the International scientific conference*, November 18-19, 2019, Blagoveshchensk, Russia. Blagoveshchensk: Amur State University, pp. 196-200.

KHOLOPOV, A.A., FEDOTOV, A.S., STREMEDLOVSKAYA, US, POLOVNIKOVA, I.V. (2019). *The use of modern methods for transfer pricing in Russia and other countries.* Finansovaya ekonomika, 417, 985-988.

KRASNOV, A., OKANOVA, A., YERALIYEVA, Y., KOZHAKHMETOVA, M., KARSHALOVA, A., AITKAZINA, M. (2020). *Development of the financial policy of the Eurasian economic union countries: tax harmonization.* Entrepreneurship and Sustainability Issues, 8(1), 138-149.

LAZAREVA, E.A. (2016). *The international experience of transfer pricing.* In: XI Prokhorov's readings devoted to the 85th anniversary of the Volga State University of Water Transport. Collection of articles by participants of the Eleventh Prokhorov Readings, December 23, 2015, Nizhny Novgorod, Russia. FGBOU VO "VGUVT", pp. 101-104.

MAKHOVIKOVA, G.A. (2014). *Pricing: student's textbook and practical guide*. The 6th revised and enlarged edition. Moscow: Izdatelstvo Yurait, 463 p.

MAZURINA, T.YU., MATKOVSKAYA, YA.S., NEOPULO, K.L., ROGULENKO, T.M. (2020). *Studying the impact of the depreciation policy on the development of innovation potential of industrial enterprises*. *Entrepreneurship and sustainability issues*, 7(3), 1513-1526.

Nalogovyi kodeks Rossiiskoi Federatsii chast pervaya ot 31 iyulya 1998 g. No. 146-FZ i chast vtoraya ot 5 avgusta 2000 g. No. 117-FZ *Tax Code of the Russian Federation Part One of July 31, 1998 No. 146-FZ and Part Two of August 5, 2000 No. 117-FZ* (the current version of July 31, 2020 and September 30, 2020). *Collection of Legislation of the RF* 03.08.1998, No. 31, Item 3824; 07.08.2000, No. 32, Item 3340.

NEIGHBOUR, J. (January 2002). *Transfer pricing: Keeping it at arm's length*. *OECD Observer*, 230.

NIKITINA, A.V., ZAHAROVA, L.N., LOBANOVA, B.B., VUKOVICH, G.G. (2020). Actualization of building mutually beneficial relationship with staff as a condition for the development of the company's marketing strategy. *International Journal of Management*, 11(9), 187-193.

OECD. (2017a). *Model Tax Convention on Income and on Capital: Condensed Version 2017*. Paris: OECD Publishing.

OECD. (2017b). *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Paris: OECD Publishing

SAYDULAEV, D.D., BEZPALOV, V.V., DEEVA, T.V. (2020). Cloud-based CRM systems: Analysis of Technologies and Opportunities to Communicate with Consumers. *International Journal of Advanced Trends in Computer Science and Engineering*, 9(4), 6717-6723.

ZAİKINA, O., RUBCHENKO, M. (2008). *The price of transferring prices*. *Ekspert-online*, 5, 58-62.

ZHANG, W., YUAN, YU., HU, YA., NANDAKUMAR, K., CHOPRA, A., SIM, S., DE CARO, A. (2019). Blockchain-Based Distributed Compliance in Multinational Corporations' Cross-Border Intercompany Transactions, in: K. Arai, S. Kapoor, R. Bhatia (eds.), *Advances in Information and Communication Networks*. FICC 2018. *Advances in Intelligent Systems and Computing*, vol 887. Cham: Springer, pp. 304-320.

ZUBENKO, V.V., DANILKEVICH, L.I., LOZITSKAYA, O.I., STEPANOV, D.A. (2020). Securities market regulation: *national and international aspects of the key instruments' functioning*. *Revista Inclusiones*, 7(Especial), 175-185.